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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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TIPS AND ADVICE. Despite the recent ragged performance of the general market I am constantly being asked, "What can I buy to make money?" Strangely enough, I seldom hear the question, "What can I do to avoid taking losses?" One way to avoid losses, of course, is to refrain from buying when the averages are saying "caution". Few people realize that investing implies avoiding losses as much as it does capturing profits. The prime purpose of these Letters is to teach the implications of the averages as an aid to investment and business management. I have made no attempt to put out an "advisory service" or "tip" sheet. Those who have mastered the Dow Theory need no advice; moreover, they have learned to avoid tips like the plague.

DIVERGENCE. When the averages move in opposite directions for two days or longer, the "gears" of the market are "grinding" and caution is the watchword. Many severe declines and reactions have been tipped off by the refusal of the two averages to move together, particularly during extended, high-volume advances.

It is my belief that the recent divergence, taken in an area of relatively low volume, is not necessarily a bearish sign. The market, viewed over the broad picture, has grown dull both n advances and declines. This may imply an inability to muster sufficient buying power at these levels, and if this is the case, a retreat to and a testing of lower levels may be needed before a general advance can begin again. Letter 67 stated: "It would now be perfectly normal for the averages to correct at least 1/3 to 2/3 of the advance from T." (See Chart) This is exactly what has happened. It is the action following whatever decline lows are now being established which will give us a clue as to the strength of the market. If the new lows hold and volume diminishes as they are approached again, it will be a fairly bullish sign. If, following an advance from the new lows, the rally fizzles and the two averages then turn around and violate the new decline lows on high volume it will be a danger signal and a prediction of lower prices to come.

Note that the rail average has declined in a steady series of downward steps. Although the carriers appear weak at first glance, this could be a period of consolidation. I would take a more bearish view of rails if that average formed a definite downward zig-zag (in other words if, following the next rail rally, the carriers failed to better their 169.67 highs at pt. W, and they then declined and broke their last low point). A descending zig-zag formation in either or both averages is always a much more bearish indication than a mere backing off of one or both averages. Often on a mere straight-line decline the market is doing what Hamilton called "reculer pour mieux sauter", or stepping back to leap better.

THE MARKET. Recent Letters have discussed the indecisive volume indications both on advances and declines together with the divergence in the two averages. In Letter 67 I carefully outlined my reasons for being "cautious". That this caution was justified can be seen from the following statistics pertaining to last week's trading: total issues traded - 1,418; advances - 504; declines - 773.

Through the combined intelligence of the market, the averages are now appraising the bullish or bearish possibilities of the period ahead. They are taking into consideration the flight of gold from this country, the emergence of stiff European business competition, the effects of a steel strike and perhaps higher wages, the tightening of money rates and a sagging bond market, together with the chances of further business improvement, an incipient capital goods boom, and the likelihood of higher corporate earnings during the remainder of this year and

next. A downward zig-zag pattern in both averages with volume increasing as the decline lows are violated would imply danger in the period ahead. An upward zig-zag or a concerted thrust of both averages above the recent highs (pt. W on chart - indust. 643.79, rails 169.67) on higher volume would imply still further improvement in the business picture and correspondingly higher security prices.

Study the chart below carefully. Note the lack of upside volume on any advance since mid-March, also the divergence and decreasing volume on the May 21 rail confirmation. The sharp break of the "line" at pt. T brought out the highest volume since early March and the implications of this line break were discussed at the time.

STOCKS. Although I have not been advocating the purchase of stocks for a number of weeks now (and my reasons were carefully explained in Letters 64 through 67), readers still insist that I name stocks or groups for purchase. If purchases must be made I suggest they be executed only on the appearance of an orthodox Dow buy spot. Taking whatever lows are now being established, if the market should rally (on expanding volume)- then decline on diminishing volume and one or both averages holds above the earlier lows - we might then have a high level (and far from satisfactory) buy spot. I, for one, will not add stocks to my portfolio unless a good-sized correction takes place, regardless of whether the market advances from this area or not.

(written- June 4, 1959- 5 P.M.)